

6-2015

Consumption by Destination: The Practical Aspects of Adopting the Destination Principle

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Recommended Citation

Gerald A. Byrnes, *Consumption by Destination: The Practical Aspects of Adopting the Destination Principle*, 66 HASTINGS L.J. 1443 (2015).

Available at: https://repository.uchastings.edu/hastings_law_journal/vol66/iss5/6

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Notes

Consumption by Destination: The Practical Aspects of Adopting the Destination Principle

GERALD A. BYRNES*

Corporate tax reform has been a “hot button” tax issue for numerous years now. The complex and inefficient double taxation model has proven to be particularly ill equipped to properly tax large multinational entities. One popular idea to solve these concerns is to switch to a consumption tax. However, there are still questions about how to model said tax, particularly in the international context: should a country tax be based on where products are destined for, or on where they originate? This Note focuses on the practical appeal of preferring the destination principle to the origin principle, should the United States adopt a corporate consumption tax. The practical benefits include aligning with international standards, facilitating corporate tax compliance in moving to the new system, preventing base erosion, and addressing complex tax issues such as the treatment of intellectual property across international lines.

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INTRODUCTION

Very few doubt that the U.S. tax system needs an overhaul. An old and outmoded system, our current income tax model is inefficient, overly complicated, and stifles economic growth in the United States. These critiques have only grown as our economy has become more international, allowing for an increased flow of goods, services, and capital across international boundaries. Moreover, multinational companies have taken advantage of this increased globalization—and the different tax rules of other countries—to exploit gaps in competing tax codes and create less than “single” taxation. This problem has been well documented,¹ but scholars cannot agree on the best solution to address the issue.

One well-known reform idea is to change the U.S. tax system, in whole or in part, from an income tax to a consumption tax. A consumption tax taxes “consumption,” or *spending*, as opposed to the attainment of wealth. Scholars have propounded several different models of a consumption tax,² all of which are aimed at addressing issues within the current system, including: corporate double taxation, the different treatment of debt versus equity, and how corporations have used their multinational status purely to achieve tax benefits that lack justification in economic reality.

1. See, e.g., Ian Pollock, *Corporation Tax: Easy for Multinationals to Avoid?*, BBC NEWS (Apr. 5, 2012, 10:38 PM), <http://www.bbc.com/news/business-17625874>.

2. See generally Daniel N. Shavero, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91 (2004) (explaining the various types of progressive consumption taxes).

One critical component of a consumption tax that changes from iteration to iteration is whether to tax on a “destination” or “origin” principle. Although both tend to lead to the same result in the long run, at least economically, the destination principle has been featured more prominently, both in scholarly articles and in real-world implementations.³ When considering how to implement a consumption tax, U.S. tax reformers have focused on the destination principle because, practically speaking, it is an easier system to implement and is also able to achieve the goals that make a consumption tax desirable.

In Part I, this Note discusses the background of corporate and international taxation in the United States. Part II presents the various problems that have arisen in our current tax system, including issues faced by U.S. businesses competing in international markets, the pandemic of business flight and inversions, and the establishment of offshore tax havens. Part III argues the merits of adopting the destination principle, assuming the United States adopts a corporate consumption tax. These merits are largely based upon the practical advantages of the destination principle: most major trading partners of the United States have already adopted it; it is largely analogous to current de facto territoriality; it combats tax base erosion; and it best resolves difficult tax issues, exemplified by the taxation of intellectual property. Finally, Part IV responds to two of the main critiques of the destination principle: its effect on current tax revenue and its disadvantages when compared to the origin principle.

I. CONTEMPORARY U.S. TAXATION OF DOMESTIC CORPORATIONS

As a general proposition, U.S. corporations are treated as distinct taxpayers, separate from their shareholders.⁴ The United States currently taxes domestic corporations upon the corporation’s worldwide income.⁵ Thus, the corporation is taxed any time it acquires wealth, irrespective of the transaction that leads to that wealth. This has helped, at least in part, generate an overly complicated tax system because the U.S. tax system must account for how foreign tax systems might tax the same item of

3. See, e.g., Noël B. Cunningham & Mitchell L. Engler, *Prescription for Corporate Income Tax Reform: A Corporate Consumption Tax*, 66 TAX L. REV. 445, 452 (2013). In arguing for the benefits of the destination principle, this Note presumes that most countries have adopted the destination principle, which is currently true. However, should more countries adopt the origin principle for their tax system, some of these benefits would be undermined. For example, double taxation would occur if a company was manufacturing goods in Country A (with the origin principle) for consumption in Country B (with the destination principle).

4. *Corporations*, INTERNAL REVENUE SERV., <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Corporations> (last updated Nov. 12, 2014).

5. I.R.C. § 11 (West 2015).

income.⁶ Preventing double taxation of income is one of the core norms of international taxation, and is usually accomplished through bilateral tax treaties.⁷ According to the Congressional Budget Office (“CBO”), the United States currently has one of the highest statutory corporate tax rates—39.3 percent—in the entire Organization for Economic Cooperation and Development (“OECD”), surpassed only by Germany and Japan.⁸

A corporation’s foreign-sourced passive income is taxed immediately, while nonpassive income earned from foreign sources is taxed when the corporation “repatriates” the income.⁹ This worldwide taxation differs remarkably from the territorial taxation system that most developed countries use.¹⁰ Under a territorial taxation system, the taxing government only includes the income from that territory in the tax base; income from foreign sources is simply excluded.¹¹ In contrast to a territorial tax system, the United States has jurisdiction to tax all areas where U.S. citizens or resident aliens earn income worldwide, as interpreted by the Supreme Court.¹²

This worldwide posture, however, is mitigated by provisions of current U.S. tax law. Under sections 901–909 of the Internal Revenue Code (“IRC”), taxpayers are allowed a credit against their U.S. income tax for the foreign income tax they paid on a particular item of income.¹³ In a nod to international comity, and to prevent double taxation, the United States allows foreign governments the first crack at taxation. This credit is the logical result of a tax system that acknowledges that active

6. *Tax Reform*, H. COMM. ON WAYS & MEANS, <http://tax.house.gov> (last visited June 9, 2015) (describing generally the broad economic benefits that would result from simplification of the current U.S. tax system); *Tax Reform Option Papers*, SENATE COMM. ON FINANCE, <http://www.finance.senate.gov/issue/?id=6c61b1e9-7203-4af0-b356-357388612063> (last visited June 9, 2015) (describing the complicated rules that apply to U.S. taxpayers who earn money from foreign sources). Both chambers have identified a complicated U.S. tax code in need of reform.

7. See generally Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT’L TAX & BUS. LAW. 1, 10–13 (1986).

8. CONG. BUDGET OFFICE, CORPORATE INCOME TAX RATES: INTERNATIONAL COMPARISONS 14–15 (2005).

9. “Passive income” refers generally to income earned from sources that do not require active participation. See I.R.C. § 469 (West 2015) (providing the statutory definition of passive income). “Repatriate” refers to when the corporation brings foreign income into the domestic United States. John Barrasso, *Territorial v. Worldwide Taxation*, SENATE REPUBLICAN POL’Y COMM. (Sept. 19, 2012), <http://www.rpc.senate.gov/policy-papers/territorial-vs-worldwide-taxation>; Kitty Richards & John Craig, *Offshore Corporate Profits: The Only Thing ‘Trapped’ Is Tax Revenue*, CTR. FOR AM. PROGRESS (Jan. 9, 2014), <http://www.americanprogress.org/issues/tax-reform/report/2014/01/09/81681/offshore-corporate-profits-the-only-thing-trapped-is-tax-revenue>.

10. Barrasso, *supra* note 9.

11. *Territorial Tax System*, NASDAQ, <http://www.nasdaq.com/investing/glossary/t/territorial-tax-system> (last visited June 9, 2015) (defining territorial tax system).

12. *Cook v. Tait*, 265 U.S. 47 (1924) (finding Congress had the power to tax income of nonresident citizens from property not situated within the United States).

13. I.R.C. §§ 901–09 (West 2015).

income should be “sourced” (and thus taxed) where it is earned.¹⁴ If the FTC is fully applicable against U.S. taxation, the result is that the corporation only needs to pay foreign tax on foreign income and no U.S. tax, creating a de facto territoriality taxation system.¹⁵ This de facto territoriality helps ensure that international taxpayers are subjected to the lowest amount of double taxation possible.¹⁶

II. CONSEQUENCES OF THE CURRENT SYSTEM

What may have once been a workable system has proven to be inefficient and burdensome in light of the increased globalization of the twenty-first century. Globalization has increased international trade, manufacturing, and financing. As nations develop and become more capable of providing these services, the United States has been held back by its current form of international corporate taxation and relatively high corporate taxation rate.¹⁷

A. LACK OF INTERNATIONAL COMPETITIVENESS

One of the biggest concerns of U.S. tax policymakers is that the worldwide taxation of U.S. companies hinders their ability to compete with international companies abroad.¹⁸ This is partly due to the fact that the U.S. corporate tax rate remains relatively high,¹⁹ as compared to the rest of the global economy. According to at least one scholar, “[p]artly in response to the increased openness of economies, corporate tax rates have trended downwards abroad.”²⁰ Developing countries have lowered tax rates in order to both increase the competitiveness of their domestic corporations at home and to attract foreign companies looking to relocate.²¹ As a consequence, U.S. companies paying U.S. taxation are often forced to pay more in taxes than their foreign counterparts on the same income, and

14. Donald J. Rousslang, *Foreign Tax Credit*, TAX POL’Y CTR., <http://www.taxpolicycenter.org/taxtopics/encyclopedia/Foreign-Tax-Credit.cfm> (last visited June 9, 2015).

15. *Id.*

16. ORG. FOR ECON. COOPERATION AND DEV., ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL, art. 23 (Jan. 28, 2003).

17. Charles Scaliger, *Major U.S. Companies Park Money Overseas to Save on Taxes*, NEW AM. (Mar. 13, 2013), <http://www.thenewamerican.com/economy/sectors/item/14765-major-u-s-companies-park-money-overseas-to-save-on-taxes>.

18. DOUGLAS HOLTZ-EAKIN & GORDON GRAY, HERITAGE FOUND., GLOBAL COMPETITIVENESS AND THE CORPORATION INCOME TAX (Apr. 30, 2009), <http://www.heritage.org/research/reports/2009/04/global-competitiveness-and-the-corporation-income-tax>.

19. *Id.*; see also ALAN J. AUERBACH, CTR. FOR AM. PROGRESS, A MODERN CORPORATE TAX 2 (2010).

20. AUERBACH, *supra* note 19, at 5.

21. S.M. ALI ABBAS & ALEXANDER KLEMM, INT’L MONETARY FUND, A PARTIAL RACE TO THE BOTTOM: CORPORATE TAX DEVELOPMENTS IN EMERGING AND DEVELOPING ECONOMIES 21 (2012); AUERBACH, *supra* note 19, at 5.

[w]ith top combined state and federal corporate tax rates at about 40 percent, the United States—once the ‘land of opportunity’ and of free-market enterprise—now has the highest corporate tax rate in the developed world, and a federal government frantically looking for further corporate tax ‘loopholes’ to close that will raise rates higher still.²²

For example, consider the situation where U.S. Corp. earns \$100 in a hypothetical country, subject to U.S. taxation of thirty-five percent, as compared to Foreign Corp., which earns \$100 in the same hypothetical country subject to taxation of twenty percent. On these facts, Foreign Corp. would pay \$20 to its nation’s taxing authority, while U.S. Corp. would pay \$35—\$20 to the hypothetical country, which would generate a \$20 FTC that brings the U.S. tax liability down to \$15. Thus, U.S. Corp. ends up with \$15 less to reinvest in its foreign business than Foreign Corp. does.

These concerns about competitiveness are felt by both businesspersons and politicians, on both sides of the political line. David Cote, the CEO of Honeywell, has said that the shareholder level tax was appropriate, but that taxing “the companies that are in the middle of trying to compete with new and growing firms” would be a huge mistake.²³ Proponents of the worldwide taxation approach counter that if the United States does not tax on a worldwide basis, companies will still be incentivized to move their profits and capital away from the United States because of the increased tax benefits.²⁴ Both the House Ways and Means Committee and Senate Finance Committee have issued reports identifying the anticompetitive impact of U.S. tax policy that U.S. corporations face while operating abroad.²⁵ In February 2014, the House Ways and Means Committee published a legislative discussion draft involving an extensive overhaul of the tax system, including the U.S. treatment of corporations.²⁶ At the very least, it is clear that tax reform is

22. Scaliger, *supra* note 17.

23. Ernest Scheyder, *Honeywell CEO Urges Sharply Lower U.S. Corporate Tax Rate*, REUTERS, Nov. 21, 2013, <http://www.reuters.com/article/2013/11/21/us-honeywell-cote-idUSBRE9AK1AT20131121>.

24. AUERBACH, *supra* note 19, at 10.

25. Press Release, House Comm. on Ways and Means, *Camp Releases International Tax Reform Plan to Strengthen the Economy and Make the Tax Code Simpler, Fairer and Flatter* (Feb. 26, 2014), available at www.waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=370987; *International Competitiveness*, SENATE COMM. ON FINANCE, <http://www.finance.senate.gov/issue/?id=0587e4b4-9f98-4a70-85b0-0033c4f14883> (last visited June 9, 2015).

26. See HOUSE COMM. ON WAYS & MEANS, *WAYS AND MEANS, 112th Cong., 1st Sess., DISCUSSION DRAFT BILL TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO PROVIDE FOR COMPREHENSIVE INCOME TAX REFORM* (Feb. 21, 2014), available at http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft_022614.pdf; Bernie Becker & Kevin Bogardus, *Baucus Puts Nail in Tax Reform Coffin*, HILL (Dec. 20, 2013, 6:00 AM), <http://thehill.com/blogs/on-the-money/domestic-taxes/193712-tax-reform-even-less-likely-if-baucus-becomes-ambassador-to> (explaining how former Sen. Baucus, now U.S. Ambassador to China, attempted to push through tax reform, but left office before it could be accomplished).

a concern taken seriously by both major political groups in the U.S. government.

B. BUSINESS FLIGHT

The current corporate tax system has also had the unintended effect of spurring many U.S. corporations to reincorporate or move abroad. Many corporations have argued that the only relief from high U.S. rates is to re-designate as a foreign company abroad.²⁷ While the process to reincorporate can itself be a substantial cost, the drop in effective tax rates is often a sufficient benefit to ameliorate the sting.²⁸ For example, Applied Materials' move abroad dropped its effective tax rate from twenty-two to seventeen percent, which would result in a tax savings of \$100 million for that year.²⁹

Congress has actively tried to respond to business flight by increasing taxes when companies attempt to reincorporate abroad. In 2004, for example, Congress passed section 4985 of the IRC, which "imposes a special tax of 15 percent on restricted stock and options held by the most senior executives when a company reincorporates outside the United States."³⁰ Other measures aim to prevent this flight by continuing to treat expatriated companies as domestic, despite reincorporation.³¹ Such punitive measures, however, have proven largely unsuccessful.³² Even following the passage of section 4985, major U.S. companies like Omnicom Group, Inc., Applied Materials, Inc., and others have reincorporated in lower-tax nations.³³ The companies will either structure the reincorporation to lessen the tax burden on their executives, or simply foot the tax bill as a cost of doing business.³⁴ Undoubtedly, these expenditures will be worth the long-term tax savings to these corporations, as the United States is ill-equipped to deal with this fact because "the basic outlines of the U.S. corporate-tax system are little-changed since the Kennedy years, when America didn't have to worry about attracting and keeping business."³⁵ Unfortunately, globalization has eroded the economic foundations that lead to the

27. John D. McKinnon & Scott Thurm, *Business and Taxes: U.S. Firms Move Abroad—Despite '04 Law, Companies Reincorporate Overseas, Saving Big Sums on Taxes*, WALL ST. J., Aug. 29, 2012, at B.1.

28. Zachary Mider, *Companies Fleeing Taxes Pay CEOs Extra as Law Backfires*, BLOOMBERG (Jan. 26, 2014, 9:01 PM), <http://www.bloomberg.com/news/2014-01-27/companies-fleeing-taxes-pay-ceos-extra-as-law-backfires.html>.

29. David Gelles, *New Corporate Tax Shelter: A Merger Abroad*, N.Y. TIMES, Oct. 9, 2013, at B.1.

30. Mider, *supra* note 28; see also I.R.C. § 4985 (West 2015).

31. I.R.C. § 7874 (West 2015).

32. See Mider, *supra* note 28.

33. *Id.*

34. *Id.*

35. John D. McKinnon, *Lower-Tax Shores Draw U.S. Firms*, WALL ST. J., June 24, 2011, at B.1.

economic preeminence that the United States enjoyed, and the United States will have to be more responsive to the course of global economics.

C. THE RISE OF THE “TAX HAVEN”

In addition to business flight, the excessively high tax rate on a U.S. corporation’s worldwide income is also demonstrated by the increasingly complex ways these companies mitigate and reduce their U.S. tax liability—mainly through the use of “tax havens.”³⁶ First, companies can plan to have their income flow through holding companies in countries with low tax rates.³⁷ Through careful structuring abroad, the company can even achieve the desired goal of paying no foreign taxes.³⁸ While the corporation cannot avail itself of the domestic FTC in this situation, the corporation will not face domestic taxation until they repatriate the earnings back to the United States.³⁹ By keeping their earnings abroad, companies can take advantage of the time-value of that money, and the United States is denied that value until the money is repatriated.⁴⁰

One of the most illustrative examples of the complexity involved in reducing tax liability is Apple Inc.⁴¹ Apple directs its foreign sales, or sixty percent of its profits, through Irish subsidiaries—Ireland being a well-known tax haven.⁴² Through special local residence rules, Apple is allowed to declare itself as located nowhere—and hence, if there is no residence, there is no jurisdiction to tax.⁴³ Additionally, under U.S. Treasury Regulations, Apple has the option to “check the box” and have its foreign subsidiaries be treated as pass-through entities for U.S. tax purposes, rather than being treated as independent corporations that must recognize income and pay taxes.⁴⁴ Such a structure saved Apple at least \$44 billion in U.S. taxes from 2010 to 2013.⁴⁵ Apple’s smart accounting tricks have saved it billions in tax revenue, and it is hardly

36. *Id.*

37. Lee Sheppard, *How Does Apple Avoid Taxes?*, FORBES (May 28, 2013, 7:46 PM), <http://www.forbes.com/sites/leesheppard/2013/05/28/how-does-apple-avoid-taxes>.

38. Scott Thurm & Kate Linebaugh, *More Profits Parked Offshore*, WALL ST. J., Mar. 11, 2013, at B.1.

39. Richard Rubin, *Baucus Proposes Minimum U.S. Tax on Foreign Earnings*, BLOOMBERG (Nov. 19, 2013, 2:08 PM), <http://www.bloomberg.com/news/2013-11-19/baucus-proposes-minimum-u-s-tax-on-foreign-earnings.html>.

40. William Baldwin, *Making Tax Deferral Pay Off*, FORBES (May 19, 2011), <http://www.forbes.com/sites/baldwin/2011/05/19/making-tax-deferral-pay-off>.

41. See Sheppard, *supra* note 37.

42. *Id.*

43. *Id.*

44. Howard Gleckman, *The Real Story on Apple’s Tax Avoidance: How Ordinary It Is*, FORBES (May 21, 2013, 4:58 PM), <http://www.forbes.com/sites/beltway/2013/05/21/the-real-story-about-apples-tax-avoidance-how-ordinary-it-is/>.

45. See Sheppard, *supra* note 37.

alone: many U.S.-based multinational companies have adopted similar strategies to create elaborate tax havens.⁴⁶

Together, these issues underscore the substantial concerns created by the current tax regime in the United States. The overall failure of measures to halt the emigration of U.S. companies to foreign countries should be taken as a sign that punitive methods do not work, at least not without resulting in major losses to domestic tax revenue. As political discussions have recently acknowledged, the appropriate solution is to revamp the current system of taxation and recognize the issues that plague U.S. businesses trying to establish an international presence.⁴⁷

III. REFORM: A CONSUMPTION TAX BASED ON A *DESTINATION* PRINCIPLE

One of the most prominent alternative methods put forward by proponents of tax reform is to replace the corporate income tax with a corporate consumption tax. Essentially, a consumption tax taxes the taxpayer's *spending* or *consumption* rather than taxing accessions to wealth.⁴⁸ There are several variations of a consumption tax—ranging from a sales tax to the Value Added Tax commonly used throughout Europe.⁴⁹ Both sides of the aisle support the adoption of a consumption tax in the United States because it is revenue neutral and, in the corporate context, has the potential to mitigate double taxation.

This Note focuses on one aspect of the consumption tax that varies from model to application: whether the consumption tax will be based on an “origins” principle or a “destination” principle. Under the origins principle, the “tax is ultimately levied only on production . . . the key difference between the two is that imports must be brought into tax under the destination principle (so far as they contribute to consumption) and exports ultimately must be excluded, and conversely under the origin principle.”⁵⁰ To illustrate, consider the following example: Suppose a corporation in Country A manufactured and sold widgets both at home and internationally in Country B. If the taxing authority of Country A incorporates the destination principle in its consumption tax, then the

46. *Move Over, Apple: 16 More U.S. Companies Stashing Billions Overseas*, DAILY FIN. (July 3, 2013, 10:34 AM), <http://www.dailyfinance.com/2013/05/22/tax-dodging-us-companies-billions-overseas>.

47. John Lechleiter, *To Guarantee the U.S.'s Economic Future, We Need Tax Reform Now*, FORBES (Jan. 15, 2014), <http://www.forbes.com/sites/johnlechleiter/2014/01/15/to-guarantee-the-u-s-s-economic-future-we-need-tax-reform-now>.

48. Al Ehrbar, *Consumption Tax*, CONCISE ENCYCLOPEDIA OF ECON. (2007), <http://www.econlib.org/library/Enc/ConsumptionTax.html>.

49. John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CALIF. L. REV. 2095, 2109 (2000) (“[A consumption tax] is a tax on a base that consists of ‘consumption’ (somehow defined), regardless of the tax rate, rates, or rate system used.”).

50. Michael Keen & Walter Hellerstein, *Interjurisdictional Issues in the Design of a VAT*, 63 TAX L. REV. 359, 360 (2010).

revenue from the goods bound for Country B would not be included in the corporation's taxable income for Country A. Rather, Country B would have the right to include that revenue in the corporation's taxable income, assuming Country B also relied upon a similar tax system.

The destination principle is often achieved by assigning a "zero rate" to exports—essentially, to exclude them from the tax base—and to assign a positive rate to imports.⁵¹ If the product is to be used within the taxing authority's territory, then it is subject to the authority's jurisdiction to tax. In the words of the OECD, "[t]he application of the destination principle achieves neutrality in international trade and would improve efficiency."⁵² Under the destination principle,

the corporate tax would be assessed based on where a corporation's products are used rather than where the corporation is located or where the goods are produced. Assessing the tax based on where a firm's products are used eliminates issues of where to locate a business and incentives for U.S.-domiciled businesses to shift profits abroad to reduce U.S. taxes.⁵³

Assuming that the United States adopts a corporate consumption tax, it would be better served to implement the destination principle because this principle helps achieve what is most appealing about a consumption tax: the prevention of tax base erosion and profit shifting. As will be discussed, this principle helps achieve these two goals in a practical manner: the United States would conform with international norms for taxation; companies could easily switch to this system; profit shifting could be easily prevented through careful definitions; and taxing authorities could more easily tackle complex tax issues, such as the taxation of intellectual property used internationally.

A. INTERNATIONAL COMITY

If the United States decides to adopt a corporate-level consumption tax, it would do well to base it on the destination principle. First, a destination principle would closely mirror the *de facto* territoriality taxation that is the current U.S. norm. Under the current FTC rules, the United States cedes the proverbial "first bite" of the apple to a foreign authority, but it retains the right to tax income that the foreign authority does not tax.⁵⁴ Adopting a destination principle mirrors the current approach: as the foreign authority currently taxes income earned abroad, this principle cedes the authority to tax goods bound for that jurisdiction.

51. Bert Mesdom, *VAT and Cross-Border Trade: Do Border Adjustments Make VAT a Fair Tax?*, in *THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA* 192, 197 (2011).

52. NAOKI OKA, *ORG. FOR ECON. COOPERATION AND DEV., TAXING CROSS-BORDER SUPPLY OF SERVICES AND INTANGIBLES I* (2013).

53. AUERBACH, *supra* note 19, at 3.

54. I.R.C. §§ 901–09 (West 2015).

However, a “pure” territoriality system embraces more closely the ethos of international comity, whereas the FTC is merely a nod to that comity. By adopting the destination principle, the United States would not retain the right to tax spending on items destined offshore, which would eliminate the need for FTCs in the first place, as there would be no potential for double taxation.⁵⁵

Consider the following example: In Country X, domestic company A and foreign company B are both subject to the same taxation if they wish to do business in X (assuming that B’s home country is one that has adopted a destination principle too). X will have the jurisdiction to tax both A and B, and B will not suffer any double taxation. As B’s home country will have no basis to tax B’s activities in X, B’s home country does not need to develop a system of FTCs to mirror this result.

As far as an international standard can be determined, “[t]he destination principle—and with revenue accruing to the country of import—is the norm in international trade, and sanctioned by World Trade Organization (‘WTO’) rules.”⁵⁶ Indeed, one of the biggest proponents of the destination principle is the OECD, which has published a set of draft guidelines addressing how to implement a consumption tax in an international context.⁵⁷ In the words of the OECD, “the destination principle places all firms competing in a given jurisdiction on an even footing.”⁵⁸ This has the effect of achieving neutrality in international trade.⁵⁹ These guidelines feature two core concepts: (1) the notion that a consumption tax should be neutral for business, and (2) the destination principle itself. Many member countries of the OECD are prominent U.S. trading partners, and thus, have similarly adopted the destination principle and eliminated unnecessary international competition.⁶⁰ By continuing to follow an income tax system, the United States continues to hinder its ability to compete in the global economy.

B. FACILITATING CORPORATE COMPLIANCE

The importance of adopting a consumption tax system that is functionally similar to our current income system cannot be understated. In 2012, the Internal Revenue Service (“IRS”) estimated that based on

55. William B. Barker, *International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure Tax*, 30 NW. J. INTL L. & BUS. 647, 691 (2010).

56. See Keen & Hellerstein, *supra* note 50, at 361–62.

57. ORG. FOR ECON. COOPERATION AND DEV., OECD INTERNATIONAL VAT/GST GUIDELINES 12 (2013), available at <http://www.oecd.org/ctp/consumption/ConsolidatedGuidelines20130131.pdf>.

58. *Id.*

59. *Id.*

60. *List of OECD Member Countries—Ratification of the Convention on the OECD*, ORG. FOR ECON. COOPERATION AND DEV., <http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm> (last visited June 9, 2015).

costs for filing 2009 federal income tax returns, U.S. businesses spent \$110 billion in tax compliance each year.⁶¹ While certain provisions of the IRC allow deductions for tax preparation expenses, the amount is still significant.⁶² Any attempt to adopt a consumption tax in the United States should strive to implement a familiar system, lest it force domestic corporations to spend billions complying with an unfamiliar system.

Many current tax reform proposals address the overarching problem of a confusing and complicated tax system. Adopting a basis for taxation that differs substantially from the current system would undoubtedly generate increased compliance costs, at least initially. If the goal of tax reform is to make compliance easier both to achieve and to understand, such an adoption is surely counterintuitive. Such a move is particularly illogical if the goal of reform is to facilitate one's ability to understand how one is being taxed.

Indeed, David Camp, the Republican chairman of the Ways and Means Committee, endorsed the switch to a territorial taxation system as part of larger attempt to untangle the current tax compliance system.⁶³ Rep. Camp encouraged this particular reform in the hopes of easing the repatriation of international profits while encouraging businesses to not move abroad.⁶⁴ However, Rep. Camp wished to leave the current corporate tax system as one that taxes *income* rather than *consumption*.⁶⁵ Still, his concern is valid: the move to a system that excludes foreign jurisdictions from the tax base would ease compliance efforts for companies. This ease is certainly a factor that members of Congress can and should account for. As reported, "[t]he nonpartisan joint committee on taxation reckons Rep. Camp's plan favours neither rich nor poor relative to the current system."⁶⁶ Further, an independent study of Rep. Camp's draft "suggests that implementing the proposals of the Camp discussion draft would have positive net effects on the macroeconomic performance of the economy."⁶⁷ The overall results of the study indicated that Rep. Camp's draft reform would result in an overall increase in gross domestic product ("GDP"), both in the short term and long term.⁶⁸ While this is somewhat inapposite given that the Camp draft still

61. GEORGE CONTOS ET AL., INTERNAL REVENUE SERV., TAXPAYER COMPLIANCE COSTS FOR CORPORATIONS AND PARTNERSHIPS: A NEW LOOK 7, available at <http://www.irs.gov/pub/irs-soi/12rescontaxpaycompliance.pdf>.

62. 26 C.F.R. § 1.212-1(l) (2015) (allowing expenses paid in connection with preparing the tax return to be deducted for an individual).

63. *Reforming Taxes: Here's a Plan*, ECONOMIST, Mar. 1, 2014, at 30.

64. *Id.*

65. JOHN W. DIAMOND & GEORGE R. ZODROW, TAX POLICY ADVISERS LLC, DYNAMIC MACROECONOMIC ESTIMATES OF THE EFFECTS OF CHAIRMAN CAMP'S 2014 TAX REFORM DISCUSSION DRAFT (2014).

66. *Reforming Taxes: Here's a Plan*, *supra* note 63.

67. DIAMOND & ZODROW, *supra* note 65, at 2.

68. *Id.* at 9.

retained an income-based approach to taxation for corporations, it does suggest that the move to a territorial system (referred to as a “participation exemption system”⁶⁹ in the independent study), as part of a larger set of tax reforms, could help contribute to overall economic improvement. Identifying the “destination principle” as the consumption-tax analog of a territorial system, one can then see that adopting the destination principle for tax reform leads to the same result.

C. SHIFTING PROFITS ABROAD

Adopting a destination principle could prevent profit shifting. Profit shifting, at its simplest, occurs when multinational companies shift their profits to low tax jurisdictions.⁷⁰ Corporations often accomplish profit shifting by attributing profits to different jurisdictions and setting prices between associated entities—multinational enterprises ensure that they set up branches in low-tax jurisdictions for this very reason.⁷¹ This profit shifting, or base erosion, seriously undermines the tax base, causing losses in revenue due to exploitation of a regime’s international tax system.

The destination principle addresses this problematic price shifting by simply removing exports from the tax base, thereby eliminating a large chunk of the motivation for transfer-pricing practice. The elimination of taxes on foreign-sourced income (as destined for foreign jurisdictions) and the exclusion of cross-border transactions would create a “super territorial system—one that ignores not only activities that occur abroad, but also those going and coming.”⁷² According to Professor Auerbach, such a system would no longer allow profit shifting “because such shifting would no longer be possible.”⁷³ In Auerbach’s examples, the profit shifting methods employed, which either underreport sales to foreign subsidiaries or overstate interest on a loan from a related entity, have no impact upon the U.S. tax base because they are not included within the base and cannot be deducted against the base.⁷⁴ Put differently, the consumption tax—based upon the destination principle—simply does not include within its tax base the framework by which multinational companies currently move profits around.

69. *Id.* at 14.

70. ORG. FOR ECON. COOPERATION AND DEV., *supra* note 57, at 15.

71. *Id.* at 38–42.

72. AUERBACH, *supra* note 19, at 10.

73. *Id.* This is in comparison to a simple territorial system, the de facto standard for most of the world, because companies can shift their activities to low tax countries.

74. AUERBACH, *supra* note 19, at 11.

Comparatively, Rep. Camp's proposal to include income from intellectual property under Subpart F taxation⁷⁵ is one method that would prevent the hoarding of income aboard; controlled foreign corporations ("CFC"s) are taxed on certain items of income irrespective of whether they have actually made a dividend or repatriated the income.⁷⁶ The United States seems to be leaning toward an expansion of CFC taxation rules, likely because that expansion would still be less significant than overhauling the entire tax code into a consumption tax—which would be a drastic endeavor, even if it only applied to corporations. Further, Rep. Camp's legislative draft appears to be stuck in reform limbo, "presumably due in part to the challenging policy compromises that such legislation would necessarily involve," along with other pending proposed reforms.⁷⁷

By contrast, the OECD's reforms to combat profit shifting are progressing as other members begin to adopt principles within anti-profit sharing plans.⁷⁸ As the international movement gains traction, it is possible that aspects of the OECD reform will become more attractive to tax reformers within the United States.⁷⁹ Adopting a destination principle as part of a corporate tax reform, per Auerbach's proposed method, does seem to be the most practical and straightforward way of combatting profit sharing.

D. TAXATION OF INTELLECTUAL PROPERTY

Finally, the destination principle would help the United States determine the appropriate way to tax intellectual property used abroad. The destination principle would closely mirror how the United States currently taxes royalties, while eliminating much of the corporate maneuvering in an efficient manner.

Currently, the United States taxes the inventory sale of intellectual property depending upon whether the sale was within the United States.⁸⁰ If the intellectual property is personal property, the property is

75. Subpart F taxation refers to sections 951–65 of the I.R.C., which tax a U.S. parent corporation on transfers of income between the parent's corporate subsidiaries even if no income is ever repatriated to the United States. I.R.C. §§ 951–65 (West 2015).

76. Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 370–71 (2013); see also I.R.C. §§ 951–65 for the statutory mechanism for taxing a corporation's income that has not been repatriated.

77. Paul W. Oosterhuis & Moshe Spinowitz, *US Corporate Tax Reform: Stuck in Neutral*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Jan. 16, 2014), <http://www.skadden.com/insights/us-corporate-tax-reform-stuck-neutral>.

78. James Anderson & Chris Hutley Hurst, *Base Erosion and Profit Shifting: Key UK Issues*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Jan. 16, 2014), <http://www.skadden.com/insights/base-erosion-and-profit-shifting-key-uk-issues>.

79. Oosterhuis & Spinowitz, *supra* note 77.

80. I.R.C. § 861 (West 2015).

sourced⁸¹ to the residence of the seller; if the seller is a U.S. resident or citizen, it is subject to U.S. tax.⁸² The United States taxes royalties from the licensing of intellectual property based upon where the property is intended to be used.⁸³ If the property is to be used within the United States, it is deemed to be sourced from within the United States, and therefore is subject to taxation.

Addressing intellectual property in any tax reform is necessary to prevent erosion of the tax base. Currently, U.S. companies can establish foreign subsidiaries in low-tax jurisdictions and license the intellectual property to themselves. In a survey of how international companies game the current tax system, the Joint Committee on Taxation found:

The [company] designated an entity in a low-tax jurisdiction as a “principal” and then transferred a significant portion of its IP to that principal. Once the IP had been transferred to the principal, the low-tax jurisdiction taxed the IP income, even when the underlying R&D took place in a higher-tax country. The benefits of these kinds of transfers are enhanced whenever the principal pays an artificially low price for the higher-taxed entity’s IP.⁸⁴

Rep. Camp, previously mentioned in Part III.A, has proposed the use of a “patent box” that “would include controlled foreign corporations’ . . . worldwide income derived from intangibles.”⁸⁵ The effectiveness of patent boxes, whether in stimulating technological growth or ensuring that some international revenue is taxed, is still unproven.⁸⁶ Reform, however, is clearly necessary. Complex business planning schemes like the “Double Irish Dutch Sandwich” allow companies whose main product is intellectual property to “deflect IP income to low- or zero-tax countries even in circumstances where the value of the IP was created in the United States and the resulting products are sold in the United States.”⁸⁷

Unfortunately, the effectiveness of including income from intellectual property under Subpart F taxation is questionable. The requirements to

81. In international tax, “source” refers to the location where the item of income is determined to have arisen. This is important because, depending on where an item of income is sourced, it may or may not be included in a country’s tax base. For example, a country might “source” income from personal services to where the personal services were performed and only include personal services sourced within that country in the tax base—thus, a citizen of that country who performed personal services abroad would not include income from those services within her taxable income for that country.

82. I.R.C. § 865.

83. *Id.* § 861(a)(4).

84. Graetz & Doud, *supra* note 76, at 395.

85. *Id.* at 370–71 (citing H. COMM. ON WAYS & MEANS, 112TH CONG., TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME 34 (2011), available at http://waysandmeans.house.gov/uploadedfiles/final_te_--_ways_and_means_participation_exemption_discussion_draft.pdf).

86. *Id.* at 375.

87. *Id.* at 400–01. For an introduction to the Double Irish Dutch Sandwich, see Stephen C. Loomis, *The Double Irish Sandwich: Reforming Overseas Tax Havens*, 43 ST. MARY’S L.J. 825, 836–42 (2012).

be a CFC subject to tax are complicated and multifaceted.⁸⁸ Merely including intellectual property within the scope of the current system would allow the current forms of corporate gamesmanship to continue unabated.⁸⁹

Adopting a destination principle in the switch to a consumption tax would be the most sensible approach in this area, if only for the problems that an origin principle would introduce. Under the origin principle, the jurisdiction taxes production within the jurisdiction and exports from the jurisdiction, while excluding imports into the jurisdiction.⁹⁰ This scheme only emphasizes the threshold issue regarding intellectual property, that is, determining where that property is actually created. Unlike personal property or real property, which has a definite existence at a particular location, intellectual property is not tethered to a physical location and can be attributed to multiple factors that come together during the creative process.

This is true even more so in the globalized economy. Multinational enterprises can fully utilize their expansive industry to create IP, but structure the arrangement so that the IP is “created” by a subsidiary in a low-tax country. While the origin principle might be attractive if the taxing jurisdiction is a net exporter, it simply fails to accommodate the complexities of “creation” for intellectual property.⁹¹ The destination principle is the preferable choice in terms of practicality: for products, wherever the good ends up is the destination; for services, the destination principle functions “as a proxy for the location of consumption” to solve controversies about where the services benefit.⁹² Just as for services, the destination principle is a sensible proxy for intellectual property.

Consider the following example. Suppose that Corporation A produces a piece of computer software, the coding of which involved workers from Countries X and Y. Country X features a corporate tax rate of thirty-five percent, while Country Y has a rate of ten percent. Corporation A wants to license the use of the software in Country Z, which has a tax rate of fifteen percent. If Countries X, Y, and Z all base their tax systems upon the origin system, Corporation A will be incentivized to characterize the creation as taking place in Country Y, while Country X would argue that the creation occurred within Country X’s borders. However, if taxes in all three jurisdictions are based upon the destination principle, then the end result is simple: Z is the country that gets to tax the production.

88. See I.R.C. § 957.

89. See Graetz & Doud, *supra* note 76, at 417.

90. See Keen & Hellerstein, *supra* note 50, at 360.

91. *Id.* at 362. Of note, the United States has been a net importer in recent years.

92. *Id.* at 367.

One issue does remain, however, in determining when a piece of IP is destined for use in a particular area. The current system solves the issue by stating that the property must be actually *used* there for the income to be *sourced* there.⁹³ Courts have had trouble distinguishing cases where a piece of intellectual property was used or consumed, rather than where it was produced or sold.⁹⁴ However, even the IRS has held that “intellectual property is used at the place of consumption.”⁹⁵ If courts were to follow the IRS’s viewpoint, they would effectively help create a more simplified and streamlined system for properly treating intellectual property.

IV. CRITICISM OF THE DESTINATION PRINCIPLE

Not all proponents of a consumption tax uniformly support the destination principle. Some scholars have taken steps to illustrate that the differences between the destination principle and the origin principle are more dependent upon economic and scholarly models rather than upon reality.⁹⁶ Two of the biggest criticisms are that the destination principle narrowly defines the tax base in a way that produces uncertain revenue results and that the origin principle is simply a preferable system.

A. UNCERTAIN REVENUE RESULTS

One concern about implementing the destination principle is whether it would actually affect U.S. tax revenue. Revenue is not necessarily the most important aspect of any proposed tax reform, and there is no consensus about how tax policy should affect revenue.⁹⁷ While some proposals are aimed at increasing revenue through tax reform, others aim to reform the tax system in a manner that simply leaves the current stream of revenue unaffected.⁹⁸

93. Erin L. Guruli, *International Taxation: Application of Source Rules to Income from Intangible Property*, 5 Hous. Bus. & Tax L.J. 205, 221 (2005).

94. See generally *Ferenc Molnar v. Comm’r*, 156 F.2d 924 (2d Cir. 1946); see also Lawrence Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 Tax L. Rev. 235, 280 (1981).

95. Lokken, *supra* note 94, at 281; see generally *Estate of Marton v. Comm’r*, 47 B.T.A. 184 (1942).

96. See, e.g., BEN LOCKWOOD ET AL., ON THE EUROPEAN UNION VAT PROPOSALS: THE SUPERIORITY OF ORIGIN OVER DESTINATION TAXATION (1994), available at <http://people.exeter.ac.uk/gdmyles/papers/pdfs/ECOANDD.pdf>.

97. See MICHAEL MAZEROV, CTR. ON BUDGET AND POL’Y PRIORITIES, ACADEMIC RESEARCH LACKS CONSENSUS ON THE IMPACT OF STATE TAX CUTS ON ECONOMIC GROWTH (June 17, 2013), www.cbpp.org/cms/?fa=view&id=3975 (providing an example of this lack of consensus in a different tax context).

98. *Business Investment and Innovation*, U.S. SENATE COMM. ON FIN., <http://www.finance.senate.gov/issue/?id=72355fe8-b834-467e-bae8-79a77f7517f8> (last visited June 9, 2015) (admitting, however, that its internal membership cannot agree on goal for revenue); Oosterhuis & Spinowitz, *supra* note 77 (discussing Sen. Baucus’s proposed reform and Camp’s reform—both claim to be revenue neutral).

It is important, however, to be able to estimate the effect of proposed reform on revenue flow. Switching to a destination principle that looks only to domestic transactions “is somewhat more difficult to assess in terms of revenue effects.”⁹⁹ Initially, one struggles to see how excluding currently taxed items from a proposed tax base could increase revenue or keep revenue neutral. Indeed, Auerbach’s proposed “Modern Corporate Tax” requires the elimination or reduction of deductions related to foreign-source income and loss of FTCs to explain how revenue could actually increase.¹⁰⁰ This approach would also involve exempting foreign dividends from U.S. taxation, and increasing tax revenue in Auerbach’s model only if the rest of his model is adopted as well.¹⁰¹

While it is hard to completely predict how the destination principle would affect current revenues, there are some obvious insights. First, the Joint Committee on Taxation (“JCT”) has estimated that a switch to a territorial tax system, under the current income tax, would “increase revenues by about \$32 billion from 2012 through 2016 and by \$76 billion from 2012 through 2021.”¹⁰² This approach would involve exempting dividends abroad from the U.S. tax base and removing deductions allocable to foreign operations.¹⁰³ The JCT’s study is not completely on point, as it still uses the current *income* tax as the background for its hypothetical move to a territorial system. However, its decision to remove deductions allocable to foreign operations does seem to bring it closer to the result of a destination-based consumption tax.

Second, adopting a consumption tax with a destination principle would encourage domestic production if taxpayers were permitted to immediately deduct their expenditures for domestic production.¹⁰⁴ Foreign companies would no longer have a tax advantage to produce or manufacture abroad if they ultimately intended to distribute their goods within the United States.¹⁰⁵ Thus, companies would be encouraged to keep or move their production into the United States, as they could then eliminate all taxation on their production costs, even if they intended to ship their goods abroad.¹⁰⁶ Ideally, the increased production in the United States would lead to additional goods manufactured for U.S. consumption, which would generate tax revenue. Theoretically, the

99. AUERBACH, *supra* note 19, at 12.

100. *Id.*

101. *Id.*

102. CONG. BUDGET OFFICE, OPTIONS FOR TAXING U.S. MULTINATIONAL CORPORATIONS 23 (2013), available at <https://www.cbo.gov/publication/43764> (citing CONG. BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS (2011)).

103. *Id.* at 21–22.

104. See Barker, *supra* note 55, at 695–96; see also AUERBACH, *supra* note 19, at 2.

105. See Barker, *supra* note 55, at 696.

106. *Id.*

increased consumption within the United States, along with disallowed FTCs and deductions for expenses related to foreign production, would help to increase domestic revenue, as reported by the CBO in 2013.¹⁰⁷

B. MERITS OF THE ORIGIN PRINCIPLE

One of the main issues with the destination principle is that it simply does not pick up the benefits the origin principle captures. The origin principle, logically, includes value created within the jurisdiction within the tax base.¹⁰⁸ A company that operates within the jurisdiction will be taxed on what it produces, whether the goods are produced for use within the jurisdiction or for export.¹⁰⁹ The origin principle helps generate consumption efficiency—consumers end up paying the same price in their residence jurisdiction, so they value those commodities similarly.¹¹⁰ Simply put, there are some attractive qualities to the origin principle.

The origin principle, however, fails to accommodate for the modern difficulties that plague international taxation. One of the biggest concerns is that the origin principle allows for the type of gamesmanship that multinational enterprises currently engage in by “[incentivizing] enterprises to establish transfer prices for their intermediate transactions so as to have value added appear to arise in low-VAT jurisdictions.”¹¹¹ In other words, the origin principle allows for the continuation of “transfer pricing” within a consumption tax system. The same incentives do not exist within a system based upon the destination principle because the prices paid to foreign jurisdictions are excluded, and thus, companies are not able to benefit from gaming foreign prices.¹¹²

Additionally, the United States is currently a net importer of goods, running a trade deficit (that is, the difference between imports and exports) of \$39.1 billion, which is an overall increase.¹¹³ It could make sense for a country to adopt the origin principle if it is a net exporter because the value of those goods is still captured within its jurisdiction. However, it is more sensible for countries that are net importers to adopt the destination principle to ensure that more value is caught within its base. The President’s Advisory Panel on Federal Tax Reform noted in its comments to adopting a consumption tax that utilizing the destination principle would generate about \$775 billion more revenue over the

107. CONG. BUDGET OFFICE, *supra* note 102, at 22.

108. See Barker, *supra* note 55, at 690.

109. *Id.*

110. See Keen & Hellerstein, *supra* note 50, at 364.

111. *Id.* at 365.

112. *Id.*

113. Martin Crutsinger, *US Trade Deficit Rose to \$39.1 Billion in January*, ASSOCIATED PRESS, Mar. 7, 2014, available at <http://bigstory.ap.org/article/us-trade-deficit-rose-391-billion-january>.

course of the report's timeframe.¹¹⁴ If implementing the destination principle ultimately turns the United States into a net exporter, then it would make more sense to switch to the origin principle.

CONCLUSION

The destination principle is the most practical solution to address U.S. taxation problems. Most of the United States' major trading partners use a tax based upon the destination principle. Thus, adopting a similar system will facilitate a complementary taxation system between the United States and those partners while ensuring the least amount of double taxation upon U.S. businesses. The advantages of the destination principle, especially in terms of international competitiveness and in preventing tax base erosion, would be especially advantageous in creating a tax reform that receives broad support from multiple groups and parties.

114. PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 172 (2005).